

Message

From: Robison, Shane [/O=COMPAQ/OU=CORP/CN=RECIPIENTS/CN=ROBISONS]
Sent: 13/09/2011 16:59:46
To: Apotheker, Leo [/O=COMPAQ/OU=EXCHANGE ADMINISTRATIVE GROUP (FYDIBOHF23SPDLT)/CN=RECIPIENTS/CN=Leoa]; Lesjak, Cathie [/O=COMPAQ/OU=TDM/cn=Recipients/cn=am-153283]; Holston, Michael [/O=COMPAQ/OU=CORP/cn=Recipients/cn=holston]
CC: Homlish, Marty [/O=COMPAQ/OU=EXCHANGE ADMINISTRATIVE GROUP (FYDIBOHF23SPDLT)/CN=RECIPIENTS/CN=Homlishm]; Johnson, Andy (Corp Dev) [/O=COMPAQ/OU=TDM/cn=Recipients/cn=johnanth]
Subject: FW: Misinformation document
Attachments: Autonomy misinformation.pdf

Very good update from Mike.

Shane Robison
Executive Vice President
Chief Strategy & Technology Officer
Hewlett-Packard Company

-----Original Message-----

From: Mike Lynch [mailto:mrl@autonomy.com]
Sent: Tuesday, September 13, 2011 7:55 AM
To: Robison, Shane
Subject: Fwd: Misinformation document

Shane,

hope you are well, Our IR people prepared a simple rebuttal to the 4 main attacks from the short hedgies over the years. You might want to give a copy to Leo so he is not blind sided. The general method is make up an erroneous calculation then state the result as fact going forward.

I don't know who to send this to so it is dealt with quickly...so you are now in IR!

Mike

United States District Court
Northern District of California

Trial Exhibit 4799

Case No: CR 18-0577 CRB

Date Entered: _____

By: _____

Deputy Clerk



Autonomy – examining the intentional misinformation

This is an overview of some of the misinformation that has been deliberately used against Autonomy over the years. This document is intended as a briefcase guide to these topics and focuses on the following areas where there have been attempts to undermine the Autonomy story and investment case:

- **Organic growth**, and the common pitfalls associated with the calculation.
- **Acquisitions**, and how ‘acquisitive’ Autonomy has actually been.
- **IDOL OEM**, how it works and the revenue profile.
- **Cash conversion**, and the effects and characteristics of Autonomy’s pure software model.

1. Organic growth

Background: Autonomy discloses its organic revenue growth calculation in each audited quarterly financial report. In the past, there have been attempts to manipulate the data to show that Autonomy’s organic growth has been lower than the publicly stated figure, usually by claiming that acquisitions have contributed more than disclosed. As the last major acquisition was in 2009 (Interwoven) the real organic growth calculation is now trivial.

NB: Autonomy considers **organic IDOL** growth to be the most meaningful performance metric for understanding the momentum within the business.

Definition: Organic IDOL growth excludes the contribution from acquisitions, foreign exchange impact, services revenue (not a goal of the business) and deferred revenue release (primarily maintenance income).

Table 1: Quarterly core IDOL organic growth

	Q1'09	Q2'09	Q3'09	Q4'09	Q1'10	Q2'10	Q3'10	Q4'10	Q1'11	Q2'11
Organic IDOL growth	19%	19%	16%	18%	29%	19%	10%	13%	19%	15%

Source: Autonomy Corp. – as disclosed in quarterly financial releases

Table 2: Organic growth calculation – core IDOL

	H1'11	H1'10	FY'10	FY'09
Total product	324.2	267.5	574	490.5
Less acquisition	-9.6	0.0	0.0	0.0
ForEx	-1.6	0.0	3.3	0.0
Add IWOV stub Q1'09	0.0	0.0	0.0	4.0
Organic revenue	313.0	267.5	577.3	494.5
Organic growth	17%		17%	

Source: Autonomy Corp.



Some of the tricks used to manipulate the organic growth numbers include:

1. ***Ignoring the margin improvement at acquired companies.*** Choosing to adopt a simplistic focus on the top line ignores the fact that the acquired businesses were typically low to zero margin, yet **EPS growth at Autonomy is very strong** (56% CAGR over the last 5 years) – demonstrating a radical improvement in profitability post acquisition, **often from 0% to 50% margin**.
2. ***Failing to account for discontinued products/services.*** Another trick has been to ignore the fact that acquired products have been discontinued by Autonomy and replaced with IDOL, and that Autonomy rapidly manages down acquired professional services after acquisition, hence the published organic IDOL growth is actually *understated*.
3. ***Overstating the contribution from acquisitions.*** We are surprised that this happens as Autonomy provides organic growth calculations in the supplementary data within its audited quarterly financial results. In recent quarters the effect of acquisitions has actually been immaterial.
4. ***Not making a countering adjustment made for disposals in the period.*** When adjusting for acquisitions, the analysts fail to adjust for the services revenues Autonomy has typically discontinued immediately following an acquisition.
5. ***Attempting to make simplistic adjustments for hardware revenue.*** Autonomy makes a limited number of appliance-based sales, which contain a small amount of hardware revenue. The trick here is to fail to adjust for the hardware that might have been in the year ago period and so understate organic growth.
6. ***Stripping out the fastest growing parts of the business.*** The fastest growing parts of the business are arbitrarily excluded from the calculation, e.g. IDOL OEM or IDOL Cloud, and the result then stated as ‘core’.
7. ***Misunderstanding the momentum in IDOL OEM.*** Autonomy has consistently signed 10 to 15 OEM agreements per quarter for many years. These lead to royalty revenues which begin to flow around 2 years later as 3rd party products with IDOL embedded come to market. Thus there is a **layering effect** as more and more products begin paying royalties each quarter.
8. ***Failure to take account of the shift to the cloud.*** Autonomy is one of the world’s most successful cloud computing companies, witnessing a rapid shift to the cloud delivery model, as customers bypass IT departments and opt for a monthly subscription model. This has the effect of lowering near term recognised license revenue but of storing up high quality, recurring revenues in the future.

NB: Autonomy’s published ‘Commit’ metric reflects cloud signings and a better reflection of underlying growth. In Q2’11 the cloud- Commit grew by 41% organic. This compares to 17% growth in recognised revenue, which obviously lags signings growth. IDOL Cloud is currently 36% of core IDOL sales.

Definition: The Autonomy ‘Commit’ metric comprises all future revenue to which Autonomy is contractually entitled. As such, it includes deferred revenue (principally maintenance income) and the committed monthly spend for cloud customers.



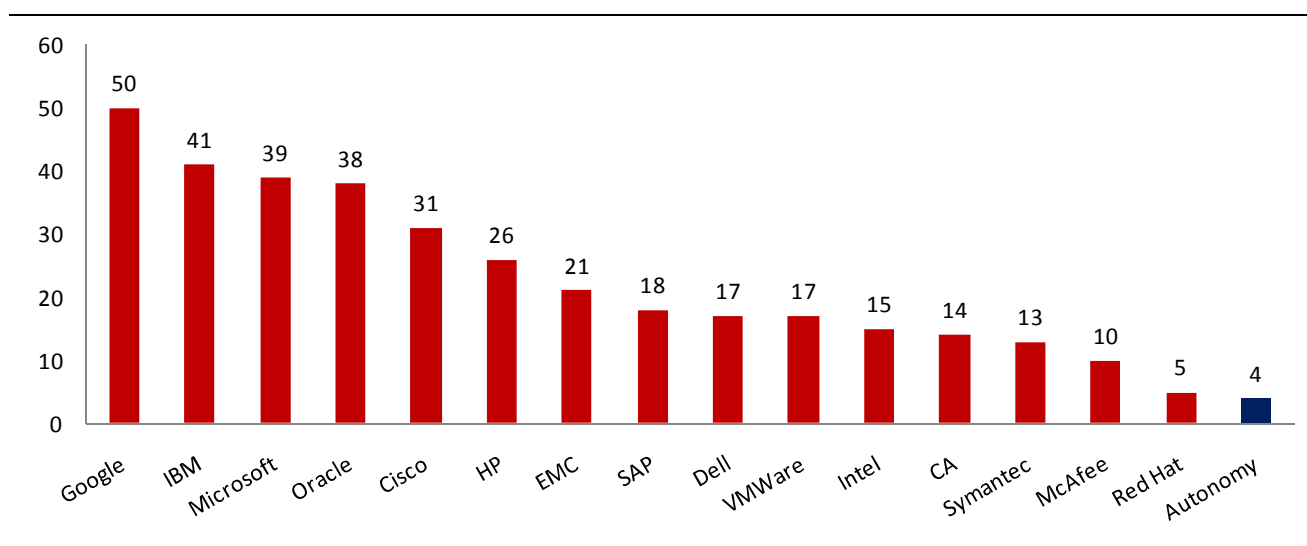
2. Acquisitions

Background: To back up the false arguments relating to organic growth, the attempt has been made to classify Autonomy as a ‘highly acquisitive company’ – implying that acquisitions have been required to sustain growth. With the passing of time this has now been shown to have been incorrect– given that the last material acquisition was in 2009 and yet growth has since continued to be strong. This most commentators who had pursued this argument have since changed their view as it has become unsupportable.

These arguments ignore the following key facts:

- 1) Autonomy has made **only four material acquisitions** since inception. By number, this is less than any other major public software company (see table 3 below).
- 2) Autonomy’s revenue has grown from \$96 million to \$1.1 billion, a 49% CAGR since 2005. Stripping out the effects of acquisitions **60% of current FY’11 consensus revenue is organic**.
- 3) The acquired businesses have been low margin, averaging just 7% net profit margin. Even back in 2005, prior to any material acquisitions, Autonomy achieved a 16% net profit margin which has now grown to >32%. In other words, **90% of Autonomy’s profit today is via organic growth**.
- 4) Since 2005, Autonomy’s market value has grown from \$450 million to \$7.3 billion. Stripping out the acquisitions and the general equity market performance, **68% of this increase in value is attributable to management** rather than acquisition.

Table 3: Number of acquisitions since 2007



* Only two material acquisitions since 2007; total acquisitions of all size in companies history since founding is seven



3. The IDOL OEM business

Background: One ploy is to suggest that the OEM business is mature, slowing, and cannibalises Autonomy's traditional software market opportunity. Another is to accept that it is growing rapidly and therefore to exclude it from any growth calculations suggesting it is unrelated to the rest of the business.

It is worth considering the following in relation to the OEM business:

1. Autonomy has **consistently signed 10 to 15 OEM** agreements per quarter for many years.
2. Autonomy initially receives a small development license fee related to these agreements, but **royalty payments begin to flow around two years later** (on average) as these 3rd party products built on IDOL eventually come to market.
3. There is a **'layering effect'** as more and more products begin paying royalties each quarter.
4. **The average royalty rate is c.4%** - this rate is likely to increase over time as customers license more of the IDOL functionality and connectors.
5. IDOL OEM is a very **efficient way to sell into the small and medium-sized business market** for enterprise software – i.e. by licensing IDOL to 3rd party products that are sold into that market segment.

Some of the more common misinformation includes:

1. ***Stating that having licensed IDOL via an OEM agreement, a competitor has all of the IDOL functionality and connectivity.*** In fact, Autonomy only licenses a small subset of IDOL functions and connectors in any given OEM arrangement. The royalty rate increases with the number of functions licensed, and 3rd party software companies are obviously reluctant to cede more of their margin than they have to. Furthermore, there can be instances where Autonomy has chosen to license only a very limited level of functionality or not to license its technology at all to certain competitors.
2. ***Asserting that when Autonomy acquires a company that is an existing OEM, there is no improvement possible by substituting IDOL for the acquired product set.*** For the reasons given above, this is untrue. IDOL includes over 500 functions and 400 connectors and OEMs only license a limited subset of these for their requirements. Autonomy has demonstrated great success in upselling IDOL functionality into acquired customer bases.
3. ***Claiming that the IDOL OEM revenues are subject to the same volatility as the enterprise software market as a whole.*** This might become true over the long term, but the current reality is that due to the layering effect (as each quarter more 3rd party products begin contributing royalties for the first time) the OEM revenue stream has shown strong growth even during the recent downturn in the enterprise software spending environment.
4. ***Claiming that IDOL OEM is completely different to selling software licenses and therefore should be stripped out of the organic revenue growth calculation.*** This is untrue, in fact Autonomy is happy for customers to 'consume' IDOL in whatever format is most appropriate, whether that be via a traditional software license, as a subscription in the cloud or by buying a competitor product and paying a royalty to Autonomy. This is a cunning way of stripping out the fastest growing part of the business.



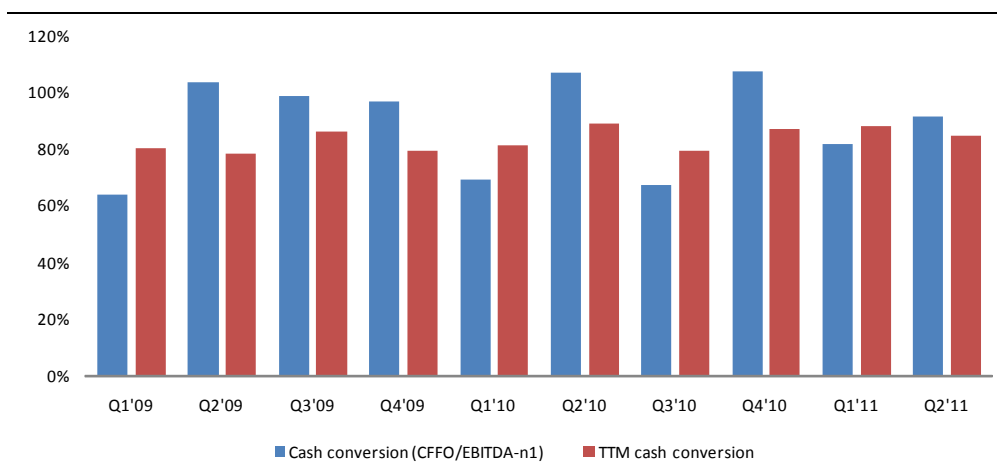
4. Cash conversion

Background: There has been commentary falsely claiming that because Autonomy's cash conversion is 90% that some customers are not paying Autonomy for its software. In fact one needs to consider cash collection, which at Autonomy is near perfect – the 'cash conversion' is simply a factor of timing of collection, growth and the usual seasonal effects.

It is worth considering the following in relation to the cash conversion metric:

1. **The calculation is actually straightforward.** Although there are different ways to calculate cash conversion we prefer to use CFFO over EBITDA, which is the most common approach. In H1'11 this was 87%.
2. **The theoretical maximum cash conversion for Autonomy, based on its growth rate, is around 90%.** With DSOs of 90 days, Autonomy is always collecting the cash in any given quarter based on the profit recorded in the previous quarter. Therefore, if the company is growing sequentially, cash conversion must be less than 100%. Cash collection at Autonomy is near perfect – with the bad debt provision at <1% sales.
3. **The negative effects of the Interwoven acquisition on working capital and cash conversion.** This is easily explained – as part of the financing of the transaction Interwoven was required to maximise its cash position immediately prior to the deal; this understandably suppressed the cash conversion metric as it unwound post acquisition over subsequent quarters.
4. **Lagged cash conversion near perfect.** With seasonal effects, the 90 day DSO range and the growth in the business, lagging the cash conversion by a quarter or by looking at the trends over the last 12 months gives a view of the underlying performance. This shows that Autonomy typically achieves 88-90% conversion, which is in line with the theoretical maximum. For example, in Q2'11 lagged conversion was 92%.
5. **Revenue to cash conversion is amongst the highest in the industry.** This was 38% in Q2'11.
6. **Pure software model.** Autonomy does not have a large professional services business which has the effect of smoothing cash conversion among other European 'peers' to whom the company is often compared, for example SAP, Sage, Logica, Dassault Systemes, and Cap Gemini.

Table 4: Lagged and trailing 12 month cash conversion, quarterly since Q1'09



Source: Autonomy Corp. – as disclosed in quarterly financial statements